

**BEFORE THE  
PUBLIC SERVICE COMMISSION  
OF MARYLAND**

IN THE MATTER OF THE  
APPLICATION OF POTOMAC  
ELECTRIC POWER COMPANY FOR  
AUTHORITY TO INCREASE ITS RATES  
AND CHARGES FOR ELECTRIC  
DISTRIBUTION SERVICE

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CASE NO. 9286

**INITIAL BRIEF OF  
MONTGOMERY COUNTY, MARYLAND**

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CASE NO. 9286

INITIAL BRIEF OF MONTGOMERY COUNTY, MARYLAND

Montgomery County, Maryland ("Montgomery County") submits this Initial Brief pursuant to Order No. 84640, issued by the Public Service Commission of Maryland ("Commission") in this proceeding on January 19, 2012.

INTRODUCTION AND SUMMARY OF ARGUMENT

In Order No. 84564, issued on December 21, 2011, in Case No. 9240, the Commission found in particular:

- (i) that Potomac Electric Power Company ("Pepco" or "Company") "has been operating at an unacceptably low level of reliability for several years,"<sup>1</sup> remaining stagnated in the bottom quartiles for reliability, and "[t]hen, in 2010, by any measure, the Company's performance deteriorated still further;"<sup>2</sup>
- (ii) that Pepco violated PUA §13-201 and accordingly would be assessed a fine of \$1 million which "sends an appropriately serious message,"<sup>3</sup> with Pepco's 2010 performance being considered "a prior violation in accordance with §13-201(d) when reviewing the adequacy of Pepco's reliability and quality of service in the future;"<sup>4</sup> and

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<sup>1</sup> Order No. 84564, In The Matter Of An Investigation Into The Reliability And Quality Of The Electric Distribution Service of Potomac Electric Power Company, Case No. 9240 (December 21, 2011) at p. 28.

<sup>2</sup> Id. at p. 32.

<sup>3</sup> Id. at p. 57.

<sup>4</sup> Id. at pp. 60-61.

(iii) that Pepco's unreliable service resulted from managerial imprudence;<sup>5</sup> accordingly, in its next rate case, Pepco would be prohibited from recovering the amount of its "reliability expenditures, including EIVM [Enhanced Integrated Vegetation Management] costs, equipment upgrades, or other parts of its REP [Reliability Enhancement Plan] expenses, made in 2011 and 2012" that is "larger due to Pepco's imprudence."<sup>6</sup>

In light of this unprecedented, stunning rebuke by the Commission in Order No. 84564 of Pepco and its management for the distressingly poor quality of service that the Company has provided to its beleaguered customers since at least as far back as 2006, and the fact that Pepco did not seek rehearing of that order, there may have been an expectation, or at least a hope, that the Company's next rate case filing would demonstrate contriteness and a recognition that Pepco certainly should not be proposing substantially increased cost recovery with reduced Commission oversight and review. Pepco would certainly understand that Order No. 84564 required that the Company would have to absorb the additional "catch up" costs – both in capital expenditures and operation and maintenance ("O&M") expenses – made necessary by its abysmal, bottom quartile reliability, resulting from its managerial imprudence.

Most unfortunately, to the contrary, as emphatically explained by Commission Chairman Nazarian to Pepco witness Gausman:

[T]he reality is we made a finding, the body that regulates you [Pepco] found that for years your company neglected its reliability performance, and that it's going to have to catch up, and we said we're going to look in the next rate case at how much you spent in the test period to do that catching up.

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<sup>5</sup> Id. at p. 60.

<sup>6</sup> Id.



And your answer to that is, well, we didn't spend anything catching up. We spent a lot more money, but of course that's what you have to do and we want it all. Not only do we want it all in the new rates, but we want you to go outside the test period and give us projected expenses on RM 43 and RM 44, and we want the RIM [Reliability Investment Recovery Mechanism].<sup>7</sup>

Montgomery County will demonstrate the extent of Pepco's stonewalling and myth making in what amounts to a collateral attack on the Order No. 84564 holding that there will be capital expenditure and O&M expense cost disallowance in Pepco's next rate case after that order, i.e., this Case No. 9286.<sup>8</sup> Based on the record in this proceeding, Montgomery County will recommend a number of cost disallowances, involving tree trimming/vegetation management, reliability capital expenditures and O&M expenses, storm costs, and Case No. 9240 regulatory costs.<sup>9</sup>

Perhaps, though, Pepco's greatest show of chutzpah in this proceeding is its proposal for a RIM. Pepco claims that it is suffering from regulatory lag worse than other utilities. Therefore, it is supposedly entitled to implement a new mechanism that will allow it to begin collecting return dollars on ostensibly reliability related capital expenditures before they have been included in any

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<sup>7</sup> Pepco Tr. 257. In this Initial Brief, citations to the transcript from the joint Delmarva Power & Light Company, Case No. 9285, and Pepco, Case No. 9286 hearing sessions are designated as "JT Tr.", and citations to the transcript from the hearing sessions concerning only Pepco, Case No. 9286 are designated as "Pepco Tr."

<sup>8</sup> Although Pepco filed Case No. 9286 on December 16, 2011, five days before the issuance of Order No. 84564 in Case No. 9240, the Commission took explicit notice of this Case No. 9286 as "the next rate case" in that order. See Order No. 84564 at p. 60 n.190 and accompanying text. As discussed later in this Initial Brief, the Commission gave Pepco numerous opportunities to meet its burden of proof to show what portion of its capital and O&M costs in 2011 and 2012 were catch up costs made necessary by Pepco's managerial imprudence, and each time Pepco declined.

<sup>9</sup> The Public Service Commission Staff ("Staff") and the Office of People's Counsel ("OPC"), have presented witnesses who have proposed numerous other downward adjustments to Pepco's cost of service. Montgomery County applauds the Staff's and OPC's efforts and generally supports these adjustments although they are not individually discussed in this Initial Brief.

rate case and reviewed by the Commission to determine that they are prudent. This proposal is breathtaking in its audacity, especially coming from Pepco.

Here we are in the first rate case after the Company has been found to be imprudent because of its management's decisions which caused it to drastically under spend for years on improving, or even maintaining, its level of reliability, leaving it in the bottom quartiles and leaving its customers, on too many occasions, without electric service. As a result, Pepco is now required to make substantial additional capital expenditures just to someday raise itself up to average reliability performance, let alone first quartile quality of service. Yet, Pepco specifically cites to the uniqueness of its situation of having to spend so much to improve reliability that is not directly related to adding new customers as its basis for the RIM. The Company cries that it will have all of these additional capital expenditures, but no new load to pay for it. In other words, because Pepco's management acted imprudently and provided woefully unreliable service, it should be rewarded with an upfront cost recovery mechanism of the additional reliability capital expenditures made necessary by its own imprudence, with the prudence review of these expenditures delayed to the some uncertain time of its next rate case.

Under the "logic" of the RIM, that next rate case -- and the RIM cost prudence review -- would be pushed back further into the future if the RIM is successful in its stated purpose of significantly reducing regulatory lag. And if it does not get its RIM or some other mechanism that thwarts current review of current, known, and measurable costs, like a totally forecasted or projected test year, well, then Pepco threatens that it will devote its management's time and effort to solving its regulatory lag by filing very frequent rate cases. If only the Company would have spent this amount of attention and manpower all of these years solving its "reliability lag" instead.

In light of the 10s if not 100s of millions of dollars in uncompensated damages that Pepco's customers in Montgomery County experienced as a result of the Company's unreliable service during major storms, non-major inclement weather events, and even on blue sky days, as documented in the record in Case No. 9240, it is simply incomprehensible that Pepco would file a rate case at the conclusion of that investigation into its managerial imprudence which seeks an annual revenue increase of \$66,207,000,<sup>10</sup> an approximately 19% increase in Pepco's Maryland distribution rates.<sup>11</sup> The biggest contributor to this proposed revenue increase is Pepco's request for an obviously bloated 10.75% rate of return on equity ("ROE"),<sup>12</sup> a considerable increase above Pepco's allowed ROE from its 2010 rate case of 9.83%,<sup>13</sup> at a time, based on current interest rates and market conditions, when a significant reduction in the current ROE is appropriate.

Moreover, the Company, in its usual heads-Pepco-wins/tails-the-customers-lose mentality, is advocating that the Commission allow Pepco to continue its Bill Stabilization Adjustment ("BSA"), which eliminates the utility's biggest risk to its revenue collection, i.e., variations in throughput due to weather, and also eliminates under collection of distribution revenues resulting from customer conservation and energy efficiency efforts. At the same time, however, the Company, which has benefitted significantly from the BSA, wants the Commission to jettison the 50 basis point reduction in the allowed ROE<sup>14</sup> that the Commission has required as its number one public policy benefit to Pepco's customers since it initially implemented the BSA in modest recognition of the very significant reduction in risk that the BSA provides to Pepco. The

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<sup>10</sup> Analysis of Proposed Rate Increase – Position by Party, line 45, col. "Pepco Revenue Requirement," filed May 18, 2012.

<sup>11</sup> Pepco Ex. 10 PEPCO (JFJ-R)-1, line 30.

<sup>12</sup> Pepco Ex. 20, p.4, lines 9-12.

<sup>13</sup> Order No. 83516, In the Matter of the Application of Potomac Electric Power Company for an Increase in Its Retail Rates for the Distribution of Electric Energy, Case No. 9217, p. 58 (August 6, 2010).

<sup>14</sup> Pepco Ex. 20, p. 69, lines 14-21.

Commission should summarily reject this proposal, and, including the 50 basis point BSA risk adjustment, the Commission should authorize an 8.43% ROE for Pepco.

In short, it is clear beyond question from the record that the only consistency in Pepco's positions on the multitude of issues in this rate case is that whatever results in more money, more quickly for the Company and its shareholders should be granted by the Commission:

CHAIRMAN NAZARIAN: . . . [Y]ou're not really disagreeing with me that inconsistency is okay if it benefits the company, right, in the eyes of Wall Street?

[PEPCO WITNESS] MS. CANNELL: Investors would certainly like to see a benefit.<sup>15</sup>

#### ARGUMENT

I. PEPCO HAS FAILED TO MEET ITS BURDEN OF PROOF ON THE ISSUE OF THE AMOUNTS OF ITS O&M EXPENSES AND CAPITAL EXPENDITURES IN 2011 AND 2012 THAT ARE LARGER DUE TO PEPCO'S IMPRUDENCE AS REQUIRED BY ORDER NO. 84564, ISSUED IN CASE NO. 9240, AFTER THE COMPANY REJECTED NUMEROUS OPPORTUNITIES IN THIS CASE NO. 9286 TO MAKE THE REQUIRED PRESENTATION.

Because Pepco had filed its rate increase application in this Case No. 9286 on December 16, 2011, five days before the issuance of Order No. 84564 in Case No. 9240, there was nothing in Pepco's prepared direct testimony accompanying its application regarding the amount of the reliability expenditures included therein whose recovery would be disallowed because they are larger as a result of the Company's imprudence, as the Commission found in Order No. 84564. Thus, at the prehearing conference held before the Commission back on January 17, 2012, counsel for Montgomery County noted the expectation that Pepco would want to include in the

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<sup>15</sup> JT Tr. 972, lines 15-20.

procedural schedule a date for the filing of supplemental testimony on this issue.<sup>16</sup> Pepco's counsel responded that: "We were not planning on filing any supplemental testimony."<sup>17</sup>

Chairman Nazarian then clearly explained:

I do think we have found that there is some element of the cost the company is incurring now that we have decided has been incurred imprudently by virtue of the company's failure to maintain its system over the course of the preceding years. So I think that's not in dispute.<sup>18</sup>

\* \* \*

They do ultimately have the burden of proof with regard to any changes in their rates.<sup>19</sup>

Despite the fact that no date was included in the procedural schedule in this proceeding for supplemental testimony, Pepco did unilaterally submit prepared supplemental direct testimony on February 27, 2012, by three witnesses. However, not one word of it addressed the issue of the amount of the catch up "reliability expenditures, including EIVM costs, equipment upgrades, or other parts of its REP expenses" that the Commission held in Order No. 84564 would not be recoverable in this next rate proceeding because of Pepco's managerial imprudence.<sup>20</sup>

Thereafter, Pepco filed extensive prepared rebuttal testimony on April 11, 2012, but again, no witness for the Company provided any amount for expenditures that were larger due to Pepco's imprudence. In fact, on cross-examination, Mr. Kamerick, Pepco's chief policy witness, was emphatic in underscoring that Pepco purposely did not present any prepared testimony

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<sup>16</sup> Prehearing Tr. 23, line10 – Prehearing Tr. 24, line 20.

<sup>17</sup> Prehearing Tr. 25, lines 2-3.

<sup>18</sup> Prehearing Tr. 26, lines 13-19.

<sup>19</sup> Prehearing Tr. 30, lines 8-10.

<sup>20</sup> Order No. 84564 at p. 60.

directly regarding the imprudence disallowance amount, and dealt with the issue only insofar as rebutting the testimony of other parties' witnesses on the subject.<sup>21</sup> Then, under questioning by Chairman Nazarian and Commissioner Brenner, Pepco witnesses Kamerick and Gausman were given numerous opportunities to attempt to meet the Company's burden of proof on this issue by coming forth with a dollar disallowance figure to respond in accordance with the Commission's holding in Order No. 84564, but they steadfastly refused.<sup>22</sup>

The truth is that as soon as Order No. 84564 was issued by the Commission on December 21, 2011, Pepco – and its parent Pepco Holdings, Inc. ("PHI") – determined that, although the Company would not seek rehearing of that order, it would simply not comply with the holding that it exclude in its just filed next rate proceeding, this Case No. 9286, the significant additional dollars spent in 2011 and to be spent in 2012 to catch up as a result of Pepco's imprudence. On December 22, 2011, the very next day after the issuance of Order No. 84564, PHI filed with the Securities and Exchange Commission ("SEC") its Form 8-K, signed by Mr. Kamerick, to divulge the existence of that order. Therein, PHI stated what this Commission's holding was, but matter-of-factly told the SEC that, nevertheless, Pepco would attempt to collect all of its expenditures from its customers:

The MDPSC also stated in the Order that it intends to review in Pepco's pending rate case the recovery of reliability costs and to disallow incremental costs it determines to be the result of imprudent management. Pepco believes its reliability costs have

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<sup>21</sup> JT Tr. 48, lines 1-20.

<sup>22</sup> JT Tr. 166, line 7 – JT Tr. 169, line 18; Pepco Tr. 250, lines 4-12; Pepco Tr. 255, line 3 – Pepco Tr. 255, line 21; Pepco Tr. 257, line 3 – Pepco Tr. 258, line 9; Pepco Tr. 259, line 19 – Pepco Tr. 260, line 22; Pepco Tr. 261, line 20 – Pepco Tr. 262, line 23.

been prudently incurred and it intends to seek to recover its expenditures in the rate case.<sup>23</sup>

As a consequence of Pepco's steadfast failure to even attempt to meet its burden of proof, the Commission should adopt the presumption that all of Pepco's additional reliability related capital expenditures and O&M expenses in 2011 and 2012 were made necessary by Pepco's imprudent, bottom quartile reliability in order to begin to catch up and eventually reach even a level of average reliability, and, as such, these costs are the responsibility of Pepco's shareholders, not its customers.

II. PEPCO'S CONTENTION THAT, DESPITE THE HOLDING IN CASE NO. 9240, ZERO DOLLARS OF ITS RELIABILITY RELATED CAPITAL EXPENDITURES AND O&M EXPENSES SHOULD BE DISALLOWED IS TOTALLY WITHOUT MERIT AND IS BASED ON FOUR FALLACIOUS MYTHS PROPOUNDED BY THE COMPANY IN THIS PROCEEDING.<sup>24</sup>

A. PEPCO MYTH NO. 1: THE ONLY MONETARY PENALTY THAT PEPCO WAS TO BEAR AS A RESULT OF ORDER NO. 84564, ISSUED IN CASE NO. 9240, WAS THE \$1 MILLION DOLLAR FINE.

In Order No. 84564, the Commission with great clarity held that:

Because of these persistent problems, the Commission finds that Pepco failed to satisfy its legal obligation to provide its customers with reliable service, and we impose a monetary penalty on Pepco in the amount of \$1 million. . . . In addition, we find that the Company's 2011 reliability expenditures were increased due to

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<sup>23</sup> PHI's SEC Form 8-K, dated December 22, 2011, at p.2.

<sup>24</sup> In light of Pepco's failure to present any evidence, let alone meet its burden of proof, on the amount to be disallowed because of its imprudence, the Commission should take an expansive approach to cost disallowance in this proceeding. This is especially appropriate because even if Pepco spends the necessary number of dollars starting in 2011 to begin the climb to at least an average or above level of reliability, if it instead had spent that same amount of money on reliability improvement during the 2006-2010 time period, its customers would have been spared the many millions of dollars of injury and very significant personal and business inconvenience that they suffered during that time, for which they will never be compensated, because of the bottom quartile reliability resulting from Pepco's imprudence.

many years of imprudently inadequate expenditures and neglect. In the Company's next rate case, the Commission will review reliability spending in 2011-2012, and will disallow the amount that is larger due to the Company's imprudent management in earlier years.<sup>25</sup>

Nevertheless, Pepco's chief policy witness Mr. Kamerick defiantly testified on cross-examination that the dollar consequence in this "next rate case," Case No. 9286, of Pepco's imprudence should be zero because, in the mind of Pepco's management, it is as if Order No. 84564 did not contain any holding on this issue:

Q. PEPCO's position [has been] that the dollar impact of Case 9240 on PEPCO's rates in this case, Number 9286, should be the same regardless of whether that Order 84564 that was issued in Case Number 9240 had found PEPCO to be imprudent, found PEPCO to be prudent, or had not been issued at all; would your answer still be that zero dollars should be disallowed in this proceeding?

A. Yes.<sup>26</sup>

Yet Mr. Kamerick admitted that Pepco did not file for rehearing of Order No. 84564's finding of Pepco's imprudence or its holding regarding the disallowance of costs in Pepco's new rate case resulting from that imprudence.<sup>27</sup> But, as he informed Commissioner Williams in response to his questioning, Pepco has put Order No. 84564 and Case No. 9240 behind it:

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<sup>25</sup> Order No. 84564 at pp. 3-4.

<sup>26</sup> JT Tr. 48, line 21 – JT Tr. 49, line 6.

<sup>27</sup> JT Tr. 45, lines 11-17.



MR. KAMERICK: I don't think how we performed in the past affects the rates we need right now, no. You know, I don't want to debate the order in 9240. We accept it. We'd like to put it behind us.<sup>28</sup>

Mr. Gausman also participated in the presentation of this myth by confirming on cross-examination that when he referred in his prepared rebuttal testimony to "the significant penalty imposed by the Commission in Case No. 9240,"<sup>29</sup> he was speaking only of the \$1 million civil penalty and not the disallowance of any costs in this Case No. 9286 because of Pepco's imprudence, as also explicitly found in Case No. 9240.<sup>30</sup>

Apparently, but entirely incorrectly, Pepco would like the Commission also to just put behind it the imprudence cost disallowance holding of Order No. 84564 in Case No. 9240 and just let bygones be bygones without any additional financial cost to the Company.

B. PEPKO MYTH NO. 2: IF PEPKO'S CAPITAL EXPENDITURES AND O&M EXPENSES ARE SHOWN TO BE PRUDENT, THEN THE COMMISSION CANNOT DENY RECOVERY EVEN THOUGH THESE INCREMENTAL COSTS WERE INCURRED TO CATCH UP AS A RESULT OF PEPKO'S IMPRUDENCE FOUND BY THE COMMISSION IN ORDER NO. 84564 IN CASE NO. 9240.

Pepco stressed in its testimony and through its counsel's cross-examination questions that the reliability expenditures that Pepco has made and is making are prudent, and, supposedly, this prevents them from being disallowed even though they are additional costs that Pepco is incurring

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<sup>28</sup> JT Tr. 164, lines 16-23. Pepco's adamant and continual refusal to acknowledge the applicability of Order No. 84564's imprudence cost disallowance holding, even though Pepco admits that this is what the Commission actually determined in Case No. 9240, brings to mind the Lewis Carroll nursery rhyme:

"Yesterday upon the stair  
I saw a man who was not there.  
He was not there again today.  
Oh, how I wish he'd go away."

<sup>29</sup> Pepco Ex. 7, p. 5, lines 4-5.

<sup>30</sup> Pepco Tr. 162, line 13 – Pepco Tr. 166, line 13.

to catch up as a result of the imprudence that the Commission found in Case No. 9240. For example, Commissioner Brenner questioned Mr. Gausman regarding why, despite the large amount shown in his prepared testimony for reliability capital expenditures in 2011 which is a very significant increase from 2010, none of it has been listed by Pepco as incremental dollars needed to catch up as a result of the Company's past imprudence. Mr. Gausman replied that: "[f]rom a capital standpoint we believe it's appropriate to obtain recovery of those costs" because "replacement of infrastructure, upgrades of our facilities we believe are prudent expenditures."<sup>31</sup>

On this same theme, Pepco's counsel asked Staff witness Schultz on cross-examination whether he had offered any evidence that the Company's actual plant closings for the test year reliability plant were imprudent and whether they were necessary to improve reliability.<sup>32</sup> However, the inquiry as to prudence is irrelevant to the determination of whether these greatly increased reliability capital expenditures were required to catch up because of Pepco's imprudence that has resulted in many years of bottom quartile reliability performance by the Company. Rather, the relevant inquiry is how much of these incremental capital expenditures "were necessary to improve reliability" because of Pepco's past imprudence found in Order No. 84564.

When the Commission held in Order No. 84564 that it would disallow in this next rate case recovery by Pepco of the amount of expenditures that is larger due to Pepco's imprudence, the Commission obviously expected that these costs incurred to improve the Company's reliability would otherwise have been recoverable as prudently incurred. If such additional costs were themselves imprudent, they would be non-recoverable in Case No. 9286 for that reason and

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<sup>31</sup> Pepco Tr. 229, line 5 – Pepco Tr. 230, line 23. See Pepco Tr. 166, line 14 – Pepco Tr. 167, line 7.

<sup>32</sup> Pepco Tr. 607, line 14 – Pepco Tr. 608, line 2.

not because of the catch up cost disallowance requirement from Case No. 9240. Of course, it is prudent to expend the funds necessary to undo past imprudence. However, that does not mean that they can be collected from ratepayers. As the Commission expressly held in Order No. 84564, “[w]e find this outcome consistent with controlling legal authority that provides ‘costs incurred by a utility company as a result of managerial imprudence cannot be recovered from the company’s customers.’”<sup>33</sup>

C. PEPCO MYTH NO. 3: THE RELIABILITY STANDARDS BEING ESTABLISHED BY THE COMMISSION IN RM 43 ARE HIGHER THAN THE LEVEL OF RELIABILITY THAT PEPCO WAS TO ACHIEVE AS A RESULT OF CASE NO. 9240; HENCE, ANY ADDITIONAL AMOUNTS SPENT FOR RELIABILITY CAPITAL EXPENDITURES AND O&M EXPENSES ARE FOR RM 43 COMPLIANCE AND NOT TO CATCH UP BECAUSE OF PEPCO’S IMPRUDENCE.

Pepco appears to be attempting to convince the Commission that if it had not determined to establish specific reliability standards in RM 43, then Pepco would not have to improve the level of its system’s reliability to at least that level as a result of Order No. 84564 in Case No. 9240. This is reminiscent of the Pepco argument that the Commission thoroughly rejected in Case No. 9240 that the Commission could not impose a penalty because of Pepco’s bottom quartile reliability because specific regulatory standards with objective metrics had not been established yet in RM 43.<sup>34</sup>

Moreover, it is important to recognize that the RM 43 standards are minimum standards that Pepco must meet regarding reliability. Certainly, to rise from the depths of the bottom reliability quartiles and its past managerial imprudence, as found in Order No. 84654, Pepco should be striving to meet the highest levels of reliability of service to its long-suffering customers in the future.

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<sup>33</sup> Order No. 84564 at p. 60 (cite omitted).

<sup>34</sup> *Id.* at pp. 61-62.

Mr. Gausman's testimony provides a stark example of this erroneous, compartmentalized approach, which attempts to negate the importance of the imprudence finding and required cost disallowance of Case No. 9240. In his prepared rebuttal testimony, Mr. Gausman states that under the RM 43 regulations, Pepco will have to achieve a 42% increase in SAIDI<sup>35</sup> and a 27% increase in SAIFI<sup>36</sup> by 2014 compared to 2010 actual performance.<sup>37</sup> He then explains that these RM 43 standards will require Pepco to increase the level of its tree trimming, maintenance and inspection work, and its storm response.<sup>38</sup>

What Mr. Gausman conveniently fails to acknowledge is that these are the very same activities the Commission held in Case No. 9240 that Pepco was so delinquent in as to be imprudent:

We find, therefore, that Pepco acted imprudently by failing to execute adequate vegetation management, by neglecting to conduct periodic inspections or after-storm patrols . . . .<sup>39</sup>

He also did not note that the Commission had determined in Case No. 9240 regarding his base line year of 2010 for measuring improvement in these areas that "we will consider Pepco's 2010 performance as a prior violation in accordance with §13-201(d) when reviewing the adequacy of Pepco's reliability and quality of service in the future."

This ploy by Pepco to make it seem as if it is required to expend greater funds to meet the RM 43 reliability standards than it would have had to if it only had to comply with Order No.

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<sup>35</sup> System Average Interruption Duration Index, which is the average time that an interruption lasts when averaged over all customers.

<sup>36</sup> System Average Interruption Frequency Index, which is the average frequency of sustained interruptions per customer.

<sup>37</sup> Pepco Ex. 7, p. 5, lines 14-19.

<sup>38</sup> *Id.* at p. 5, line 23 – p. 6, line 8.

<sup>39</sup> Order No. 84564 at p. 59.

84564 and with its already existing statutory and regulatory requirements to provide quality service to its customers<sup>40</sup> is vividly illustrated by the Company itself in Pepco Exhibit 38. This exhibit purports to show that in 2012 Pepco will experience \$4.25 million and in 2013 \$8.5 million in tree trimming O&M expenditures that it has magically attributed solely to “RM 43 Tree Trimming Compliance Costs.” Inexplicably, if the RM 43 standards had not been established, Pepco avers that it would not undertake this additional amount of tree trimming costs because apparently, in Pepco’s view, Order No. 84564 allows Pepco to stop well short of the amount of tree trimming necessary to become a reliable electric system! Pepco is even able to look into its crystal ball for next year, 2013, and know where the dividing line is between regular tree trimming costs -- \$15 million – and the incremental RM 43 required tree trimming costs – an additional \$8.5 million.

Needless to say, this is simply a preposterous assertion by Pepco. In his questioning of Mr. Gausman, Chairman Nazarian went straight to the heart of the origin of this supposed \$8.5 million in tree trimming expenses that will supposedly occur in 2013 solely because of RM 43 – it neatly gets added to make the projected total 2013 tree trimming expense \$23.5 million:

I don’t do math. But even I can look at this chart, your chart, PEPCO 38, and see that the 2011 actual and the 2013 bars are exactly the same. It’s not a coincidence. The test year total expenditure is the same as what you want going forward, right?<sup>41</sup>

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<sup>40</sup> PUA §5-303, COMAR 20.50.02.01, and COMAR 20.50.07.05A, cited in Order No. 84564 at p. 62.

<sup>41</sup> Pepco Tr. 258, lines 2-7.

D. PEPSCO MYTH NO. 4: BECAUSE PEPSCO DID NOT COLLECT ANY OF ITS ADDITIONAL EXPENDITURES DURING 2010 AND 2011 THAT WERE HIGHER THAN THE AMOUNTS PREVIOUSLY ALLOWED BY THE COMMISSION IN RATES, PEPSCO HAS ALREADY BORNE ALL OF THE COSTS DISALLOWED BY THE COMMISSION'S IMPRUDENCE FINDING IN CASE NO. 9240.

Pepco witness Gausman included in his prepared rebuttal testimony a graph purporting to show that the Company had incurred O&M expenses in 2010 and 2011 that exceeded the amounts previously included in Pepco's rates by the Commission by \$41 million and \$80 million dollars, respectively, for a total of \$121 million.<sup>42</sup> Pepco witness Kamerick's prepared rebuttal testimony then cited this \$121 million number, not once, but at least four different times,<sup>43</sup> to make the point that these dollars will never be recovered from Pepco's customers. Pepco's purpose in making this presentation was to intimate that the dollars that Pepco may not have been able to collect during 2010 and 2011 from its customers under its current rates somehow constituted the dollars that the Commission's Order No. 84564 in Case No. 9240 held would be disallowed in Pepco's next rate case – Case No. 9286 – because of Pepco's imprudence; hence, supposedly, no denial of cost recovery in Case No. 9286 is appropriate as “the Company should not be further penalized.”<sup>44</sup>

This disingenuous attempt by Pepco to nullify the application of the holding of Order No. 84564 should be summarily rejected. Order No. 84564 had absolutely nothing to do with Pepco not collecting any costs in 2010 and 2011. First of all, that order was not even issued until December 21, 2011, when 2011 was already essentially over. Second, that order was forward looking in holding that in “the next rate case,” citing the new case that had just been filed on

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<sup>42</sup> Pepco Ex. 7, p. 4, Graph 1.

<sup>43</sup> Pepco Ex. 3, p. 11, line 22 – p. 12, line 4, p.14, lines 6-10, p. 15, lines 10-13, and p. 19, lines 7-11.

<sup>44</sup> *Id.* at p. 12, lines 5-6.

December 16, 2011, it “will disallow recovery” of “the amount of expenditures that is larger due to Pepco’s imprudence.”<sup>45</sup>

Most fundamentally, Pepco’s own inaction under regular rate case procedures was the sole reason that Pepco incurred any under collection of actual O&M expenses that exceeded the amount allowed in its last rate case. Pepco could have filed a new rate case at any time after the Commission’s issuance of Order No. 83516, which decided the Company’s last rate case in Case No 9217 on August 6, 2010. However, Pepco waited until December 16, 2011, to submit its next rate increase filing in this Case No. 9286. That voluntary decision by Pepco to wait until the end of 2011 to file its new case is the sole reason why the Company was unable to collect any additional costs it bore during 2010 and 2011 above the costs included in its previously approved rates. There is nothing extraordinary about this result, and, again, any under collection has absolutely nothing to do with the Commission’s order in Case No. 9240.

On cross-examination, Mr. Kamerick was forced to acknowledge all of this. When Pepco unilaterally determined not to file a new rate case until December 16, 2011, “[w]e knew at the time that that money was never going to be recovered.”<sup>46</sup> Furthermore, he agreed that the Commission did not order Pepco not to file a rate increase application until the end of 2011 so that the Company would be unable to collect whatever additional costs it was incurring.<sup>47</sup> Mr. Kamerick also conceded that where he stated in his prepared rebuttal testimony that “the Company should not be further penalized” in juxtaposition to his discussion of the 2010 and 2011 O&M costs that Pepco allegedly did not collect from its customers, the fact is that “[w]e weren’t

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<sup>45</sup> Order No. 84564 at p. 60.

<sup>46</sup> JT Tr. 36, lines 14-15.

<sup>47</sup> JT Tr. 36, lines 18-23.

penalized by the Commission,”<sup>48</sup> and the Company’s inability to collect any 2010 and 2011 dollars did not result from any Commission order.<sup>49</sup>

III. AS A RESULT OF PEPCO’S IMPRUDENCE FOUND IN ORDER NO. 84564 IN CASE NO. 9240, SIGNIFICANT DOLLAR AMOUNTS SHOULD BE DISALLOWED IN THIS NEXT RATE PROCEEDING, CASE NO. 9286, BECAUSE THEY ARE CATCH UP COSTS MADE NECESSARY BY PEPCO’S UNACCEPTABLY LOW RELIABILITY OF SERVICE PROVIDED TO ITS CUSTOMERS.

A. THE DOWNWARD ADJUSTMENT PROPOSED BY STAFF WITNESS SCHULTZ TO PEPCO’S TREE TRIMMING/VEGETATION MANAGEMENT O&M EXPENSES SHOULD BE ADOPTED BY THE COMMISSION.

As discussed earlier in this Initial Brief, Chairman Nazarian, during his questioning of Pepco witness Gausman, underscored that Pepco is seeking to include in its O&M costs in the Company’s rates in this proceeding the same \$23.5 million amount for tree trimming/vegetation management that the Company actually incurred during the 2011 test year, as is clearly presented in Pepco’s own colorful Exhibit 38 chart.<sup>50</sup> Pepco has done this despite the explicit finding in Order No. 84564 in Case No. 9240 that:

[W]e agree with MEA, OPC and Montgomery County that it is inequitable for Pepco to have caused significant reliability problems and escalating EIVM costs as a result of years of poorly executed and underfunded vegetation management programs *and* for the Company’s ratepayers to be burdened with full repayment for the EIVM programs that are now required as a direct result of the Company’s imprudence. We find, therefore, that Pepco acted imprudently by failing to execute adequate vegetation management, by neglecting to conduct periodic inspections or after-storm patrols, by engaging in uncertain and at times contradictory tree trimming

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<sup>48</sup> JT Tr. 37, lines 1-7.

<sup>49</sup> JT Tr. 37, line 22 – JT Tr. 38, line 3.

<sup>50</sup> Pepco Tr. 258, line 1 – Pepco Tr. 259, line 3.



practices between 1999 and 2010, and by refusing to transition to a four-year tree trimming cycle, consistent with other Maryland utilities and the recommendations of the Tree Trimming Working Group.<sup>51</sup>

Vegetation management expenses surely were front and center among the categories of costs that the Commission determined in Case No. 9240 would have amounts disallowed because they were “larger due to Pepco’s imprudence.”<sup>52</sup>

Questioning of Mr. Gausman by Chairman Nazarian also exposed that what Pepco continually referred to as extra spending to “transition” its tree trimming practices, is really the very large “catch up” expenses that the Commission held would be disallowed in Case No. 9240 that are resulting from Pepco switching from a two-year trim cycle to the four-year trim cycle long used by the other Maryland utilities:

CHAIRMAN NAZARIAN: Every other company trimmed to a four-year cycle, every single other one but you, right?

MR. GAUSMAN: I believe that’s right.<sup>53</sup>

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CHAIRMAN NAZARIAN: So the transition that you talked about is incremental by its nature because everybody else was doing it the right way for ten years until you decided to do it the right way [at] the end of 2010 and 2011, right?

MR. GAUSMAN: And we’ve incurred that cost and made some changes.<sup>54</sup>

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<sup>51</sup> Order No. 84564 at p. 59 (emphasis in original).

<sup>52</sup> *Id.* at p. 60.

<sup>53</sup> Pepco Tr. 251, lines 10-13.

<sup>54</sup> Pepco Tr. 252, lines 4-10.

According to Mr. Gausman, Pepco will have completed by the end of 2012 the equivalent of a four-year trim cycle in just two and one half years<sup>55</sup> as the result of an increased level of spending.<sup>56</sup> Then, essentially, Pepco will have caught up on its tree trimming.

Because Pepco's 2011 test year tree trimming expense "reflects catch up costs and is significantly inflated because of the Company's attempt to make up for years of under spending,"<sup>57</sup> Staff witness Schultz has proposed a downward adjustment to a reasonable tree trimming spending level "for normal and routine trimming for a four year cycle trim" in accordance with the disallowance because of imprudence holding in Case No. 9240.<sup>58</sup>

Pepco's response to Staff Data Request No. 14-26<sup>59</sup> shows that Pepco trimmed 2,960 circuit miles at a cost of \$29,344,888 from the September 2010 inception of its EIVM Program through December 2011, which yields a cost per mile of \$9,913.81. Those 2,960 circuit miles constituted 72.4% of the circuit miles in Pepco's Maryland system.<sup>60</sup> Thus, the total circuit miles are 4,088 of which 27.6%, or 1,128 circuit miles remained to be trimmed during this catch up period of switching from a two-year to a four-year cycle.<sup>61</sup> At a cost of \$9,913.81 per circuit mile this would be \$11,182,778, which is virtually identical to the \$11,186,725 that Mr. Schultz calculated in his direct testimony.<sup>62</sup>

This approximately \$11.2 million is less than one half of the \$23.5 million amount that Pepco is seeking to include in its rates. Thus, as Mr. Schultz testified, "if it were assumed that no imprudence existed, the most that the Company should be allowed would be \$11.2 million."<sup>63</sup>

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<sup>55</sup> Pepco Tr. 199, line 9 – Pepco Tr. 200, line 4.

<sup>56</sup> Pepco Tr. 201, lines 4-11.

<sup>57</sup> Staff Ex. 64, p. 27, lines 19-20.

<sup>58</sup> Staff Ex. 66, p. 36, lines 2-14.

<sup>59</sup> Staff Ex. 56.

<sup>60</sup> *Id.* at p. 1; Staff Ex. 64, p. 28, lines 14-15.

<sup>61</sup> Staff Ex. 66, p. 34, lines 1-6.

<sup>62</sup> Staff Ex. 64, p. 28, lines 17-19.

<sup>63</sup> *Id.* at p. 28, lines 20-22.

However, even this number is overstated because only 1,020 circuit miles per year (1/4 of the total 4,088 circuit miles) and not 1,128 circuit miles are to be trimmed annually within a four-year cycle. Taking 1,020 circuit miles times \$9,913.81 per circuit mile yields only \$10,112,086 as the maximum annual amount IF there had been no imprudence by Pepco.

Pepco witness Gausman confirmed that the \$23.5 million spent on tree trimming during the 2011 test year was for 1,748 circuit miles.<sup>64</sup> He also conceded that once the catch up tree trimming is completed to put the Company on a four-year trim cycle, Pepco will be trimming on average only 1,020 circuit miles per year,<sup>65</sup> which Mr. Schultz emphasized is significantly less than the 1,748 circuit miles trimmed in 2011.<sup>66</sup>

To determine what the appropriate tree trimming O&M cost allowance should be in light of Pepco's imprudence, Mr. Schultz utilized information from Pepco that the Company actually plans to trim only 923.5 circuit miles during 2012. He then multiplied this by a \$7,500 per circuit mile cost that he considered to be high, which resulted in Mr. Schultz's recommended \$6,926,000 tree trimming allowance, and a reduction to Pepco's proposed \$23,519,000 of \$16,593,000.<sup>67</sup>

Actually, this \$6,926,000 amount is a liberal tree trimming allowance for Pepco because, as Mr. Schultz notes, the \$7,500 per circuit mile number "exceeds the average cost per mile for the years 2007-2011 that was unquestionably inflated due to the 2011 cost per mile."<sup>68</sup> As shown on Mr. Schultz's Exhibit LA-1, Schedule C-6, attached to his direct testimony, the "Cost/Mile"

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<sup>64</sup> Pepco Tr. 206, line 17 – Tr. 207, line 1.

<sup>65</sup> Pepco Tr. 207, lines 2-13.

<sup>66</sup> Staff Ex. 66, p. 35, lines 4-7.

<sup>67</sup> Staff Ex. 64, p. 29, line 18 – line 22 and Exhibit LA-1, Schedule 6, lines 1-3.

<sup>68</sup> *Id.* at p. 29, line 23 – p. 30, line 1. In fact, the \$7,500 per circuit mile number exceeds the actual 2007-2011 average of \$7,237, shown on Mr. Schultz's Exhibit LA-1, Schedule C-6, line 19, which he then chose to round upward to Pepco's benefit.

for Pepco's tree trimming during the 2011 test year was \$15,648, while for the other years 2007-2010, the highest year was \$6,757 in 2009, and was only \$2,347 in 2007.<sup>69</sup>

Thus, it is evident that because of the need for a huge catch up tree trimming program in 2011 resulting from Pepco's imprudence, the Company was required to pay a very steep per mile price during that year for tree trimming. Pepco witness Gausman plainly admits this in his prepared rebuttal testimony, stating that "[t]ree trimming activities alone are more aggressive than at any time in the past and result in a significant increase in the cost per mile."<sup>70</sup> This is consistent with the Commission's conclusion in Order No. 84564 that "the accelerated, enhanced vegetation management and equipment upgrades required now come at a higher cost and in a significantly more concentrated time-frame than if the Company had implemented prudent management practices in the past."<sup>71</sup> Furthermore, as Staff witness Schultz observed, "[a]lso factoring into the cost going forward is the fact that the catch-up is complete or nearly complete . . . , so it should be expected that the cost per mile would decline."<sup>72</sup> Accordingly, Mr. Schultz's proposed downward adjustment of \$16,593,000 to Pepco's tree trimming costs is, if anything, understated.

B. PEPCO'S COLLATERAL ATTACK ON ORDER NO. 84564, THROUGH ITS STONEWALLING ON THE APPROPRIATE AMOUNTS TO BE DISALLOWED BECAUSE OF ITS CATCH UP RELIABILITY RELATED CAPITAL EXPENDITURES AND O&M EXPENSES RESULTING FROM THE COMPANY'S IMPRUDENCE AS FOUND IN CASE NO. 9240, MUST NOT BE COUNTENANCED BY THE COMMISSION, AND THE MAXIMUM REASONABLE DISALLOWANCE SHOULD BE ORDERED BECAUSE PEPCO HAS COMPLETELY FAILED TO MEET ITS BURDEN OF PROOF FOR THE INCLUSION OF SUCH COSTS IN ITS RATES.

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<sup>69</sup> Id. at Exhibit LA-1, Schedule C-6, lines 13-17.

<sup>70</sup> Pepco Ex. 7, p. 6, lines 2-4.

<sup>71</sup> Order No. 84564 at p. 58.

<sup>72</sup> Staff Ex. 66, p. 35, lines 8-11.

Pepco witness Gausman in Tables 3 and 4 in his prepared direct testimony presented numbers regarding Pepco's distribution construction costs, both overall and specifically related to reliability, for the period 2007-2016 that were shocking in their stark revelation of just how little the Company invested in its system through the year 2010, i.e., the year that its performance was found to be imprudent and a prior violation in accordance with PUA §13-201(d), and, in contrast, just how much the Company started spending beginning in the year 2011.<sup>73</sup> These Tables show that Pepco's capital expenditures on Reliability during the period 2007-2010 were as low as \$29.7 million in 2007 and reached only \$39.4 million in 2010. Then, suddenly, after the scrutiny of Pepco's quality of service had begun in Case No. 9240, Pepco's Reliability capital expenditures almost tripled in 2011 to \$116.3 million, and Pepco has budgeted another \$102.9 million for Reliability capital expenditures in 2012. Similarly, Total capital expenditures ballooned from \$76.4 million in 2010 up to \$145.5 million in 2011, and are expected by the Company to be \$143.3 million in 2012.

The numbers loudly and clearly speak for themselves that Pepco has rushed to spend a very substantial amount of money to catch up on its reliability made necessary by its bottom quartile performance that resulted from its management's imprudence, as found in Order No. 84564 in Case No. 9240. However, Pepco adamantly refused to acknowledge this reality when counsel for Montgomery County put the question directly to Mr. Gausman:

Q. Is it your testimony that the greatly increased reliability expenditures of 116.3 million in 2011 and 102.9 million budgeted for 2012 and going forward as compared with reliability expenditures of only 39.4 million back in 2010 are not larger by even one dime because of PEPCO's imprudence?

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<sup>73</sup> Pepco Ex. 6, pp. 7-8.

A. That is correct.<sup>74</sup>

With Mr. Gausman's answer so obviously flying in the face of the reality of his own numbers, not to mention being in direct contradiction to the Commission's holding in Order No. 84564, Commissioner Brenner gave Mr. Gausman another opportunity to answer this fundamental inquiry:

COMMISSIONER BRENNER: Is there any portion of the reliability, talking about the capital expenses now, that whatever the figure is that have closed in 2011 that is incremental because of the need to make up for a past underachievement, underspending?

MR. GAUSMAN: We do not believe so.<sup>75</sup>

Mr. Gausman also remained at zero disallowance dollars in responding to Commissioner Brenner regarding all of the O&M costs related to reliability capital expenditures or just related to reliability in general, some of which are in categories (other than tree trimming) that the Commission also found wanting in Case No. 9240.<sup>76</sup> In fact, Mr. Gausman informed Commissioner Speakes-Backman that "I don't have the reliability dollars that are associated with maintenance in my testimony."<sup>77</sup> Consequently, Pepco has seen fit to not even inform the Commission as to how much it is spending on reliability O&M, let alone what portion of those O&M costs should be disallowed because they are larger due to Pepco's managerial imprudence.

Mr. Gausman and the other members of Pepco's management apparently did not read the holding in Order No. 84564 that cost disallowance for the Company's imprudence applies generally to "reliability expenditures, including EIVM costs, equipment upgrades, or other parts

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<sup>74</sup> Pepco Tr. 168, line 20 – Pepco Tr. 169, line 4.

<sup>75</sup> Pepco Tr. 228, lines 4-10.

<sup>76</sup> Pepco Tr. 236, line 15 – Pepco Tr. 237, line 17.

<sup>77</sup> JT Tr. 369, lines 15-17.

of its REP expenses.” Clearly, the cost disallowance in this Case No. 9286 applies to both capital expenditures and O&M costs.

Finally, Chairman Nazarian took the opportunity to review with Mr. Gausman the history of Pepco’s woefully inadequate reliability capital expenditures that caused years of unreliable service, resulting in the Case No. 9240 finding of managerial imprudence and cost disallowance:

CHAIRMAN NAZARIAN: For the years running up to 2010 before it all fell apart on you, the company’s view, the company’s position was that the year-over-year run rate, as you put it, was at this much lower level of capital spending.

MR. GAUSMAN: Yes.

CHAIRMAN NAZARIAN: Your view was that would build and that would maintain a reliable system for years on end, right?

MR. GAUSMAN: That level of expenditures was achieving a level of reliability performance hat we felt was acceptable.

CHAIRMAN NAZARIAN: And it was a level of reliability performance that put you in the bottom quartile of the surveys in which you participated, correct?

MR. GAUSMAN: Yes.<sup>78</sup>

Then the Chairman explained why Pepco suddenly began its greatly increased capital and O&M spending:

CHAIRMAN NAZARIAN: As a result of the scrutiny and as a result of the revelation of the company’s lousy reliability performance and the objective measure of the company’s lousy

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<sup>78</sup> Pepco Tr. 244, line 15 – Pepco Tr. 245, line 9. See Pepco Tr. 246, lines 5-22.

reliability performance, spending increased dramatically in 2011, the end of 2010 and through calendar year 2011, right?

MR. GAUSMAN: To achieve a higher level of performance requires an increased level of expenditures committed and we are expending.<sup>79</sup>

Mr. Gausman thus recognized that the dramatic increase in reliability expenditures in 2011 was to achieve a higher level of performance after spending so little for so long and being mired for years in the lowest quartile of reliability. Yet, on behalf of Pepco, he still would not agree, under further questioning by Chairman Nazarian, that there is any amount that Pepco spent on capital costs relating to reliability in 2011 -- the year in which it tripled its reliability capital expenditures over the 2010 year in which the Company was found to be imprudent -- because of the Company's years of previous neglect of its system.<sup>80</sup>

It is obvious from Pepco's own numbers that the Company in 2011 and 2012 has expended greatly increased amounts of money to catch up on its reliability capital expenditures as a result of its imprudent conduct in 2010 and prior years. Moreover, Mr. Gausman testified he does not know how many years it will be before Pepco's reliability improves to even slightly better than average, above the 50<sup>th</sup> percentile, second quartile performance.<sup>81</sup>

Under these circumstances where Pepco has the burden of proof, was given every opportunity to meet that burden, but steadfastly refused to place any disallowance numbers or calculations in the record, the Commission could quite appropriately deny inclusion in rate base of each and every dollar in reliability capital expenditures that Pepco made in 2011 above the 2010 level, which would be \$76.9 million dollars (\$116.3 million - \$ 39.4 million). These are

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<sup>79</sup> Pepco Tr. 248, line 17 – Pepco Tr. 249, line 3.

<sup>80</sup> Pepco Tr. 259, line 19 – Pepco Tr. 260, line 8.

<sup>81</sup> Pepco Tr. 190, line 9 – Pepco Tr. 191, line 17.



costs that should be borne by Pepco's shareholders, not its customers, because they are catch up costs just to begin the long climb up from years of bottom quartile reliability caused by managerial imprudence. At the very least, the shareholders should share these costs equally with the customers, resulting in a disallowance from rate base of \$38.45 million dollars.

Moreover, the Commission should fashion some disallowance remedy for reliability related O&M expenses for which there is a dearth of information in the record, but regarding the collection of which Pepco has the burden of proof, which it most certainly has not met. Otherwise, Pepco will have achieved its goal of turning Order No. 84564's imprudence disallowance holding from Case No. 9240 into empty words simply by failing to comply with that order through the willful and knowing refusal to meet its burden of proof in this next rate proceeding, Case No. 9286.

One alternative that the Commission should consider adopting is a reduction of 150 to 200 basis points in Pepco's authorized ROE. In Order No. 84564, the Commission found that although such a remedy for Pepco's past imprudence "may be justified under the circumstances,"<sup>82</sup> it instead opted for the disallowance of recovery by Pepco of its 2011 and 2012 catch up capital expenditures and O&M expenses.

However, in light of Pepco's steadfast refusal to even begin to meet its burden of proof regarding the appropriate size of this mandated disallowance, Chairman Nazarian warned Pepco that "to refuse to answer the question that we teed up for you I think is a dangerous strategy" that has "left a giant gap in the record."<sup>83</sup> The Commission thus is fully justified to utilize an appropriate proxy for the required imprudence disallowance for catch up reliability related capital expenditures and O&M expenses (other than the separately handled catch up tree trimming costs

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<sup>82</sup> Order No. 84564, p. 58.

<sup>83</sup> Pepco Tr. 262, lines 6-9.

discussed above). Since, according to Pepco, a change in Pepco's revenue requirement resulting from a 100 basis point change in its ROE would be approximately \$8.2 million,<sup>84</sup> a 150 to 200 basis point reduction in what would otherwise be the appropriate authorized ROE would result in an additional disallowance because of Pepco's managerial imprudence in the range of \$12.3 million to \$16.4 million.

C. STAFF WITNESS SCHULTZ'S DOWNWARD ADJUSTMENT TO PEPCO'S STORM COSTS SHOULD BE ADOPTED BY THE COMMISSION.

Staff witness Schultz has recommended that Pepco's costs associated with the January 2011 snow storm and Hurricane Irene be reduced by 25%, which reduces the deferral by \$4.809 million. This results in a reduction to rate base of \$4.329 million although rate base is also increased because of a \$1.747 million increase to deferred income taxes. Amortization expense is reduced by \$962,000.<sup>85</sup> However, Mr. Schultz did agree that a five-year amortization for the allowed portion of the storm costs would be acceptable, rather than a longer ten-year period because of the disallowance of 25% of the storm costs associated with these two storms.<sup>86</sup>

Mr. Schultz explained that this adjustment was made because of the Commission's determination in Case No. 9240 that Pepco was imprudent in its vegetation management, particularly citing the Commission's conclusion that "Pepco's history of inconsistent and sometimes contradictory tree trimming practices between 1999 and 2010 *imposed more costs and outages on customers than otherwise would have been the case* had the Company adhered to one coherent strategy."<sup>87</sup>

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<sup>84</sup> Montgomery County Ex. 2.

<sup>85</sup> Staff Ex. 64, p. 17, line 18 – p. 18, line 2 and Exhibit LA-1, Schedule C-7.

<sup>86</sup> *Id.* at p. 18, lines 4-10.

<sup>87</sup> *Id.* at p. 16, line 9 – p. 17, line 8, quoting from Order No. 84564 at p. 2 (emphasis added by Mr. Schultz).

Pepco attempted to attack Mr. Schultz's 25% cost disallowance because it was not based on a study, but rather on the reasons given by the Commission for its finding of imprudence in Case No. 9240.<sup>88</sup> First, the irony must be noted of Pepco challenging a Staff witness' particular Case No. 9240 imprudence cost disallowance adjustment because no separate study was performed when Pepco has consciously refused to make any effort to meet the burden proof, which it ultimately bears, regarding the appropriate disallowance of costs resulting from its managerial imprudence as found in that case. Moreover, Mr. Schultz explained in his surrebuttal testimony that his 25% adjustment may be too conservative,<sup>89</sup> and he expanded on his conservative approach in response to cross-examination by the Company, noting that he did not adjust for other storm costs of \$8 million included by Pepco in its test year expenses, even though Pepco had incurred only approximately \$2.8 million annually during the 2001-2010 period.<sup>90</sup>

IV. THE COMMISSION MUST DISALLOW RECOVERY OF ALL OF PEPCO'S COSTS INCURRED RELATING TO THE PROCEEDING IN CASE NO. 9240, INCLUDING, BUT NOT LIMITED TO, OUTSIDE COUNSEL AND OUTSIDE CONSULTANT COSTS.

Case No. 9240 was not a rate case or any other ordinary regulatory proceeding. Rather, the Commission docketed a separate investigation into the reliability and quality of Pepco's electric distribution system, in which the Commission concluded in Order No. 84564 that Pepco had for years been providing bottom quartile, unreliable service to its customers, causing them very significant monetary and personal harm and inconvenience, which resulted from the imprudent conduct of Pepco's management:

Pepco's customers have paid a substantial price for Pepco's neglect, measured not just by direct economic costs such as closures of businesses leading to lost wages and reduced tax revenue, but

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<sup>88</sup> See Pepco Tr. 609, lines 3-8.

<sup>89</sup> Staff Ex. 66, p. 19, lines 10-23.

<sup>90</sup> Pepco Tr. 609, line 19 – Pepco Tr. 610, line 8.

also by less tangible costs, including the physical discomfort caused by multiple outages and the uncertainty of knowing when persistent outages will end.<sup>91</sup>

Pepco was assessed a \$1 million civil penalty and barred from recovering in this next rate proceeding, Case No. 9286, all capital and O&M expenditures that are larger due to the Company's imprudence. The money spent by Pepco in unsuccessfully attempting to defend itself in Case No. 9240 was solely on behalf of and for the benefit of Pepco's shareholders, and it would be inappropriate in the extreme for Pepco to obtain even one nickel of reimbursement from its customers, who were the parties harmed by Pepco's imprudence and unreliable service.

In all of its prepared testimony, Pepco did not divulge to the Commission the number of dollars of Case No. 9240 regulatory costs that it had placed in the O&M expenses to be included in the rates to be charged to its customers in this proceeding. Only when Pepco witness Hook was presented on cross-examination with Pepco's Response to Montgomery County's Data Request No. 1, Question 10, which showed that Pepco had in 2011 expended more than \$3.2 million dollars in Case No. 9240, including in excess of \$1.8 million on outside counsel, greater than \$1.2 million on outside consultants, and even almost \$175,816 in "Miscellaneous Charges,"<sup>92</sup> did Pepco reveal that all of the Case No. 9240 costs that Pepco is attempting to collect are embedded within its total \$237,988,000 "Operation and Maintenance" expense.<sup>93</sup>

In response to a bench request from Chairman Nazarian, Ms. Hook provided Pepco Exhibit 55 on the last day of the hearing in this proceeding, which showed that, although Pepco

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<sup>91</sup> Order No. 84564 at p. 3.

<sup>92</sup> Montgomery County Ex. 4.

<sup>93</sup> Pepco Tr. 30, line 14 – Pepco Tr. 31, line 15; Pepco Ex. 34, Exhibit (LH-R)-1, p. 1, line 19, column (1).

had incurred \$3,236,003.26 of outside regulatory expenses for Case No. 9240,<sup>94</sup> because of the manner in which some of the dollars had been booked, Pepco was able to include “only” \$2,517,574.03 in the O&M expenses that it is seeking to collect from its customers in this proceeding.<sup>95</sup> It should be noted that, as revealed on Pepco Exhibit 55, the assignment by Pepco of more than \$1.7 million dollars of Case No. 9240 outside legal costs to FERC Account 923 underscores the Company’s own recognition that the investigation into Pepco’s unreliable service and managerial imprudence was not a rate case or other normal regulatory proceeding before this Commission, the cost of which would be directly charged to Pepco’s Maryland distribution system in FERC Account 928.<sup>96</sup>

Staff witness Schultz proposed in his prepared direct testimony that all of the regulatory costs from Case No. 9240 that Pepco seeks to collect should be amortized over five years.<sup>97</sup> Once he became aware through the presentation of Pepco Ex. 55 that the correct number was \$2,517,574.03, he adopted that number,<sup>98</sup> which would result in a downward adjustment of \$2,058,000 to Pepco’s proposed revenue requirement.<sup>99</sup> Even Pepco witness Hook tacitly conceded in her prepared rebuttal testimony that the Company’s costs associated with Case No. 9240 are of a different nature by stating that that Pepco would not oppose amortizing them over a two-year period.<sup>100</sup>

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<sup>94</sup> Footnote 2 to Pepco Ex. 55 explains the slight difference between the \$3,218,753 “Grand Total” on Montgomery County Ex. 4 and the \$3,236,003.26 “Total Case No. 9240 Expense” on Pepco Ex. 55, line 11.

<sup>95</sup> Pepco Ex. 55 at p. 1 and p. 2, line 17. Pepco witness Hook attested twice to Chairman Nazarian that the \$2,517,574.03 represents all of the test year expenses that Pepco is seeking to recover in this rate case in connection with Case No. 9240. Pepco Tr. 700, lines 1-9; Pepco Tr. 704, line 16 – Tr. 705, line 4.

<sup>96</sup> See Pepco Tr. 685, line 19 – Pepco Tr. 686, line 9; Pepco Tr. 690, lines 7-14

<sup>97</sup> Staff Ex. 64, p. 41, lines 13-14.

<sup>98</sup> Pepco Tr. 635, lines 12-20.

<sup>99</sup> Analysis of Proposed Rate Increase – Position by Party, line 34, column “Staff Revenue Requirement,” filed May 18, 2012.

<sup>100</sup> Pepco Ex. 34, p. 52, lines 10-12.

However, as Mr. Schultz notes in his direct testimony, “based on the decision in Case No. 9240, [these regulatory costs] could be questioned as either non-recurring or inappropriate due to the imprudence determination,”<sup>101</sup> and reiterated in his surrebuttal testimony that “I firmly believe that a case could be made for disallowing those costs altogether.”<sup>102</sup> Montgomery County firmly believes that it would be entirely unjust and inequitable for Pepco to recover any of its Case No. 9240 costs from its customers even over a lengthy amortization period and that the case unquestionably has been conclusively made for the Commission disallowing those costs altogether.

V. PEPCO’S ASSERTION THAT BECAUSE OF THE EFFECT OF REGULATORY LAG INHERENT IN TRADITIONAL RATE REGULATION, THE COMPANY IS UNIQUELY DESERVING OF SPECIAL RATE TREATMENT THROUGH A MECHANISM SUCH AS A RIM OR A FORECASTED TEST YEAR, IS WITHOUT MERIT AND SHOULD BE REJECTED.

Traditional cost of service rate making, utilizing a recent historical test year, with the allowance of certain post-test year “known and measurable” adjustments, permits a synchronization of costs and revenues, and gives a utility a reasonable opportunity to earn a fair rate of return regarding those investments properly included in its rate base and to recover the expenses properly included in its cost of service. It avoids single issue ratemaking, where the only outcome can be increased revenue for the utility without reviewing all other cost categories that might yield offsetting cost decreases.

Through the regulatory lag that is inherent in traditional rate making,<sup>103</sup> the opportunity exists for a utility which operates efficiently to over earn the ROE established in its rate case. On

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<sup>101</sup> Staff Ex. 64, p. 41, lines 11-13.

<sup>102</sup> Staff Ex. 66, p. 39, lines 15-16.

<sup>103</sup> Mr. Lowry, Pepco’s outside consultant whose testimony contained the academic, theoretical presentation of the Company’s RIM proposal, agreed that regulatory lag is inherent in traditional approaches to regulation and is not at all a new phenomenon. JT Tr. 241, lines 8-15.

the other hand, a utility that has acted imprudently or inefficiently may not perform well after its new rates become effective, and, as a result, may not earn its allowed ROE. There is nothing extraordinary about this – some utilities respond to the incentive of regulatory lag in a positive way, and others, do not do as well because of their own less than stellar management decisions and performance.

These latter utilities typically threaten to file more frequent rate cases if they do not receive special treatment to alleviate the alleged negative effects of regulatory lag. All that this threat does, though, is magnify the inherent bias in the existing regulatory process in the utility's favor that whenever it is over earning, it can merrily go along doing so indefinitely unless the rare event occurs of a regulatory commission, either on its own motion or in response to a complaint by another party, determining to conduct a full investigation into that utility's rates. In sharp contrast, at any time that the utility believes that it can obtain higher rates from a regulatory commission, it is free to file a new rate increase application. This asymmetrical situation gives the utility the tool that it needs to obtain any legitimate relief that it might actually require from the effects of regulatory lag.

In addition, this Commission has already afforded utilities, such as Pepco, with plenty of protection from the effects of regulatory lag and generally reduced what otherwise would pose significant risk of current revenue under collection through the approval of automatic revenue tracking provisions, such as the BSA and the EmPOWER Maryland surcharge, and regulatory asset treatment, such as for AMI/smart meters. Further erosion of historical test year, cost and revenue matching ratemaking should be rejected by this Commission for any utility absent a showing by that utility of the most compelling, extraordinary circumstances that are unrelated to the utility's own imprudence or incompetence.

This Commission has rejected attempts by other utilities to significantly distort the matching of costs and revenues that takes place in cost of service rate making. Most recently, in Order No. 84475,<sup>104</sup> in denying a request by Washington Gas Light Company (“WGL”) in Case No. 9267 to implement a surcharge for collection of the increased infrastructure investments of its accelerated pipe replacement program, the Commission explained that it was not frightened by the possibility that rejection of WGL’s proposal could well result in that utility filing more frequent rate cases – a threat repeated several times by Pepco in the instant proceeding.<sup>105</sup>

We recognize that accelerating its pipe replacement program may require the Company to file somewhat more frequent rate cases than it would prefer. That is not, in our view, a negative outcome – rate cases afford all parties, and this Commission, the opportunity to ensure that rates are just and reasonable, and we understand that accelerated infrastructure investment may require more frequent adjustments. But ratepayers and the Company are better served if base rates are adjusted more frequently in smaller increments, and waiting longer between rate cases could lead to other undesirable results, including greater mismatches between costs and rates.<sup>106</sup>

Mr. Kamerick’s prepared direct testimony does not attempt to rebut the Commission’s holding in Case No. 9267, but rather asserts that:

Pepco’s situation differs from that of WGL in Maryland because it has been under-earning for several years, and its increased

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<sup>104</sup> Order No. 84475, In The Matter of the Application of the Washington Gas Light Company for Authority to Increase Its Existing Rates and Charges and to Revise Its Terms and Conditions for Gas Service, Case No. 9267 (November 14, 2011).

<sup>105</sup> See, e.g., Pepco Ex. 2, p. 15, lines 6-7, JT Tr. 259, lines 17-23 (Regarding the filing of frequent rate cases, Pepco witness Lowry ominously remarked that: “They will file them if they have no alternative. As you will soon find out if there’s no changes.”)

<sup>106</sup> Order No. 84475 at p.3



investment in the reliability program will only exacerbate the situation and will lead to annual or even more frequent rate cases.<sup>107</sup>

The Commission already took into account the possibility of more frequent rate cases in reaching its holding denying special rate making treatment to WGL in Order No. 84475. As to Mr. Kamerick's first contention, an examination of the evidence he cited, Table 1 on page 3 of Pepco witness Hook's direct testimony,<sup>108</sup> for his claim that Pepco is experiencing under earning which has allegedly become a chronic problem for the Company<sup>109</sup> reveals this to be more than a bit of an overstatement.

Table 1 purports to show the "Authorized" and "Earned" ROEs for Pepco in Maryland for the years 2002-2011 in an attempt to prove that Pepco has been earning less than its authorized ROE during all but one of the last ten years.<sup>110</sup> However, the first five years, i.e., 2002-2006, Mr. Kamerick admitted, were rate cap years,<sup>111</sup> in which settlement agreements that Pepco voluntarily entered into applied, which did not state any authorized ROE.<sup>112</sup>

Ms. Hook's own direct testimony then concedes that in 2008, the year following the Commission's implementation of the BSA tracker for Pepco's benefit, the Company, according to it Table 1 numbers, had an Earned ROE of 11.24% as compared with a lower Authorized ROE of 10.00%.<sup>113</sup> Combining that with 2009, where Pepco's Earned ROE is shown as 9.29% versus a 10.00% Authorized ROE, made even Mr. Kamerick admit on cross-examination that "there are two years there that I would concede did not seem to be, quote, chronic underearning, end

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<sup>107</sup> Pepco Ex. 2, p. 15, lines 2-7.

<sup>108</sup> Pepco Ex. 32, p. 3, lines 12-13.

<sup>109</sup> Pepco Ex. 2, p. 11, lines 19-21 and p. 15, lines 8-9.

<sup>110</sup> Pepco Ex. 32, p. 3, lines 6-11.

<sup>111</sup> JT Tr. 185, lines 11-15.

<sup>112</sup> JT Tr. 56, line 2 – JT Tr. 57, line 22.

<sup>113</sup> Pepco Ex. 32, p. 3, Table 1.

quote.”<sup>114</sup> When 2007’s Earned ROE of 8.35% is included to make the three-year period that Table 1 shows as having an Authorized ROE of 10.00%, Pepco’s average Earned ROE during 2007-2009 was 9.63%,<sup>115</sup> which surely does not make that time period one of chronic under earning. In addition, as Chairman Nazarian noted during his questioning of Mr. Kamerick, Pepco was granted new rates in Case No. 9092, which although they were in effect for only half of 2007, boosted Pepco’s Earned ROE for that year to the 8.35% level.<sup>116</sup>

This leaves only the years 2010 and 2011. Obviously, a two-year period is not of such duration as to be properly characterized as “chronic” under earning. Moreover, 2010 marks the culmination of years of Pepco’s managerial imprudence which left the Company – and, more importantly, the Company’s customers – mired in the bottom quartile of reliability performance, while 2011 marks the first full year that Pepco began spending significant amounts of money to begin the process of catching up for years of imprudent system neglect, during which time, since 2004, it found sufficient funds to pay its parent PHI \$476 million in net dividends.<sup>117</sup>

To the extent that Pepco is currently experiencing under collecting, the culprit is not regulatory lag, but rather the need to drastically increase both capital and O&M expenditures in a desperate effort to increase system reliability because of the self-inflicted wound of its own chronic imprudence. This is surely not a situation where Pepco is deserving of a unique reward of a RIM or a forecasted test year because of its own past managerial imprudence and reliability performance failures. Pepco would be the last company to merit such assistance.

Yet, Pepco witness Lowry testified in response to questioning by Chairman Nazarian that the Commission should not approve his RIM proposal generally for all Maryland utilities, but

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<sup>114</sup> JT Tr. 62, lines 7-9.

<sup>115</sup> JT Tr. 60, line 15 – JT Tr. 61, line 3.

<sup>116</sup> JT Tr. 186, lines 3-5.

<sup>117</sup> Order No. 84564 at p. 57, n. 183.

instead should grant it here only for Pepco (and its sister company Delmarva) on a case-by-case basis because Pepco has shown that it is undertaking “accelerated system modernization,” so it really needs the funds:

But you could have this accelerated system modernization. That’s where you get your special case. Even at that, not every company has that big of a case to make for that. It has to be done on a case-by-case basis.<sup>118</sup>

Witness Lowry’s postulation, which provides Pepco’s basis for seeking the RIM or a forecasted test year in this proceeding, turns the Commission’s holding in Case No. 9240 on its head. Rather than the disallowance of the very large catch up costs incurred by Pepco in 2011 and 2012, as required by Order No. 84564, for “accelerated system modernization” made necessary by the Company’s years of imprudence, unreliable service, and neglect of its system, Pepco actually has the temerity to rely on this need to expend so many additional dollars to catch up on reliability as the very reason why it should be granted the special ability prospectively to collect all of the money for reliability-related capital expenditures quicker from its long-suffering customers! And this collection would be without the Commission first even determining that the expenditures are prudent, let alone whether, even if prudent, they are larger due to the Company’s past managerial imprudence and, consequently, must be disallowed from ever being recovered.

Any financial problems that Pepco experiences because it must obtain enough funds to pay for the tremendous amount of catch up capital expenditures and O&M expenses are of its own management’s making. Accordingly, no special regulatory lag relief mechanism should be bestowed on the Company. However, in reality, Pepco’s fiscal condition is not nearly as dire as the Company has attempted to portray it. As Pepco witness Cannell testified, all three rating

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<sup>118</sup> JT Tr. 288, lines 17-21.

agencies, S&P, Moody's and Fitch have given the Company investment grade credit ratings of BBB+, Baa2, and BBB+, respectively, with a stable outlook.<sup>119</sup> Mr. Kamerick affirmed that the shareholders received the full dividend, all of the bondholders received their interest, and all of Pepco's vendors, creditors, and everyone else got paid.<sup>120</sup>

Pepco witness Kamerick also contends that the Company has experienced a very low growth rate in its Maryland service territory, which has contributed to its alleged chronic under earning of its authorized ROE.<sup>121</sup> However, Table 1 in Dr. Lowry's prepared rebuttal testimony shows that the number of Pepco's residential and commercial customers in Maryland has increased in every year from 1995, the earliest year included in Table 1, through 2010, the last year shown, except for 2002.<sup>122</sup> In 1996, Pepco added 4,190 residential and 212 commercial customers, increases of 1.02% and 0.49%, respectively, while in 2010, Pepco's customer growth was larger both numerically and percentagewise, with an additional 6,828 residential and 376 commercial customers, increases of 1.44% and 0.80%, respectively.<sup>123</sup> Hence, the size and rate of Pepco's Maryland customer growth has not qualitatively changed for the worse in recent years, such that it provides a basis for the Commission to now bestow a RIM, a forecasted test year, or any other such revenue enhancing gift upon the Company.

In his questioning of Pepco's chief policy witness Kamerick, Chairman Nazarian explained precisely what Pepco is really after in this proceeding:

CHAIRMAN NAZARIAN: And again, to cut to the chase  
of what all this is about, the whole point of regulatory lag

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<sup>119</sup> Pepco Ex. 22, p. 32, lines 12-16.

<sup>120</sup> JT Tr. 194, line 11 – JT Tr. 195, line 1.

<sup>121</sup> JT Tr. 53, lines 3-17.

<sup>122</sup> Pepco Ex. 5, p. 48, Table 1.

<sup>123</sup> Id. The number of customers shown in Dr. Lowry's Table 1: Residential: 1995 – 412,311; 1996 – 416,501; 2009 – 474,836; and 2010 – 481,664; and Commercial: 1995 – 43,605; 1996 – 43,817; 2009 – 47,014; and 2010 – 47,390.

mitigation mechanisms is to get more money to the company faster from the customer to the company, right?

MR. KAMERICK: Yes. I would put it differently. . . .

CHAIRMAN NAZARIAN: . . . But the real world impact of all of this is that the money flows out of customers' pockets to the company sooner and faster, right?

MR. KAMERICK: Yes.<sup>124</sup>

Without question, the circumstances presented on the evidentiary record of this Case No. 9286 do not support the adoption of any regulatory lag mitigation mechanism that would simply drain the pockets of Pepco's customers of more money more quickly. Pepco's customers have been the victims for years of the Company's bottom quartile reliability resulting from Pepco's managerial imprudence. Such a mechanism would be particularly inappropriate in the very rate case after the issuance of Order No. 84564 in Case No. 9240, where the Commission has determined to disallow recovery of the increment of Pepco's reliability improvement expenditures that is larger because of that imprudence.

Certainly, Pepco has not met its burden of proving that this is the proceeding to make such "a significant shift in ratemaking policy" as the Commission discussed in its Order No. 84170 in Case No. 9249, involving Pepco's sister company Delmarva Power & Light Company:

We want to make clear, however, that adoption of the sort of regulatory lag mechanisms Delmarva proposes here would represent a significant shift in ratemaking policy for this Commission. In recent years, for example, we have considered and rejected Delmarva's request for surcharge recovery outside of rates for pension and other employment costs, surcharge recovery for BGE's advanced metering buildout, and opposed legislation

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<sup>124</sup> JT Tr. 206, lines 6-22.

that would mandate surcharge recovery for infrastructure expenditures. We had considered these decisions and positions carefully and explained ourselves at length, grounding them all in the fundamental ratemaking principle that surcharge recovery of core expenses precludes the full-content analysis of costs and revenues that has always ensured that rates are just and reasonable....

To the extent new and different circumstances might persuade us to deviate from the principles that have driven our recent decisions not to allow infrastructure surcharges, we would need a fully developed record and an appropriate opportunity to test the facts and the parties' arguments before we could reach such a conclusion.<sup>125</sup>

The fully developed record in this proceeding requires rejection of any type of regulatory lag mitigation mechanism for Pepco, and that is particularly true both of a fully forecasted or projected test year, which Dr. Lowry conceded is virtually entirely based on projections of revenues and expenses<sup>126</sup> and "goes beyond the known and measurable standard,"<sup>127</sup> and of the RIM, whose numerous deficiencies are highlighted below.

VI. APART FROM THE COMPLETE LACK OF ANY JUSTIFICATION FOR AWARDING PEPSCO ANY REGULATORY LAG MITIGATION MECHANISM, THE PROPOSED RIM IS, ON ITS FACE, FATAALLY FLAWED AND TOTALLY INAPPROPRIATE FOR ADOPTION UNDER ANY CIRCUMSTANCES.

Here is a litany of the more glaring flaws in the RIM proposed by Pepco for adoption by the Commission in this proceeding regarding the Company's collection of reliability related capital expenditures:

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<sup>125</sup> Order No. 84170, In the Matter of the Application of Delmarva Power & Light Company for an Increase in Its Rates for the Distribution of Electric Energy, Case No. 9249, Phases I and II (July 8, 2011) at pp. 11-12.

<sup>126</sup> JT Tr. 247, lines 11-19.

<sup>127</sup> JT Tr. 247, line 20 – JT Tr. 248, line 2.

1. There is no cap on the dollars;<sup>128</sup>
2. There is no termination date;<sup>129</sup>
3. There is no requirement that the RIM expenditures actually improve Pepco's reliability performance to any certain level;<sup>130</sup>
4. The dollars do not have to be spent on the projects listed by Pepco;<sup>131</sup>
5. The total dollars in the RIM are not limited only to capital expenditures that are denominated as "Reliability" in Pepco's construction budgets and forecasts for 2012 through 2016;<sup>132</sup>
6. The dollars do not have to be spent on any projects at all since they will be included in Pepco's commingled funds;<sup>133</sup>
7. The number of dollars in the RIM is determined by Pepco and filed with the Commission to be collected up front through a surcharge with no prudence review until the next rate case,<sup>134</sup> which, if the RIM is successful in achieving its stated purpose of eliminating or substantially reducing regulatory lag, would be pushed back by Pepco to a significantly later time;
8. Staff, OPC, and other parties with limited technical, personnel, and financial resources, if they wished to monitor the RIM, would have to participate year-round in working group sessions regarding Pepco's RIM<sup>135</sup> – and perhaps in working group sessions regarding Delmarva's RIM and the RIMs thereafter sought by all of the other utilities in Maryland;<sup>136</sup> and

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<sup>128</sup> JT Tr. 73, lines 13-15.

<sup>129</sup> OPC Ex. 19, p. 23, line 22 – p. 24, line 4.

<sup>130</sup> JT Tr. 335, line 7 – JT Tr. 336, line 4.

<sup>131</sup> JT Tr. 363, lines 6-18; JT Tr. 374, lines 4-9; JT Tr. 382, lines 9-11.

<sup>132</sup> The amount shown on the "Reliability" line of Table 4 of Mr. Gausman's prepared direct testimony, Pepco Ex. 6, p. 8, for Pepco's 2012 construction budget is \$102.9 million, but the Total RIM amount shown on his Ex. PEPCO (WMG)-1, page 4, attached to his prepared direct testimony, Pepco Ex. 6, for 2012 is a higher \$111,383,535. If the RIM included only Reliability capital expenditures, the Total RIM amount could not exceed the "Reliability" construction budget amount for the same year. Mr. Gausman explained on cross-examination that some of the 2012 construction budget amounts listed as "Load" and as "Customer Driven" are also included in the 2012 Total RIM amount. Pepco Tr. 173, line 17 – Pepco Tr. 174, line 18. The variance by which the Total RIM amounts in Mr. Gausman's Ex. Pepco (WMG)-1, Page 4, exceed the "Reliability" amounts in his Table 4 construction budget forecasts for each year 2013 through 2016 is greater than the 2012 level, reaching as high as \$28.6 million (\$124.2 million - \$95.6 million) in 2016.

<sup>133</sup> JT Tr. 363, lines 10-12; JT Tr. 382, lines 9-11; JT Tr. 387, lines 1-3.

<sup>134</sup> JT Tr. 278, line 11 – JT Tr. 279, line 21.

<sup>135</sup> JT Tr. 228, lines 13-15; JT Tr. 229, lines 4-23.

<sup>136</sup> JT Tr. 288, line 22 – JT Tr. 289, line 13.

9. The Commission would be required to approve a RIM surcharge each year up front for the number of dollars to be collected by Pepco, which amount may be spent by the Company on capital expenditures that are imprudent, are unnecessary, are overly expensive, or do not result in sufficient reliability improvement, or which amount may not even be utilized for reliability related capital expenditures.

It is mind-boggling enough that this proposal for automatic collection of the Company's reliability related capital expenditures without a prior prudence review is being made by Pepco in its first rate case after its management has been found to be imprudent and catch up costs resulting from that imprudence are to be disallowed. But it is almost equally stunning that Pepco is proposing such a precedent-setting deviation from this Commission's traditional ratemaking principles, precedents, practices, and procedures even though the principal architect of this RIM proposal, Dr. Lowry, made no evaluation of the Company's current distribution system to determine what reliability expenditures are needed and for what purpose,<sup>137</sup> and Pepco itself conducted no analysis of the effect of the Company's proposed RIM compared to traditional ratemaking approaches.<sup>138</sup>

The following colloquies regarding Pepco's proposed RIM provide a forceful summation of its fundamental deficiencies and why it should be summarily rejected by the Commission in this proceeding:

CHAIRMAN NAZARIAN: And so on the one hand you're going to put all of the parties to this process of consulting and doing discovery and getting or maintaining whatever sort of engineering and systems expertise in order to participate meaningfully in this discussion, but then all that's really going to happen at that point is a plan is going to get filed; the money will

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<sup>137</sup> OPC Ex. 5.

<sup>138</sup> OPC Ex. 8.



start flowing; and then some day later we'll figure out whether it was prudent or not?

DR. LOWRY: That's the proposal.<sup>139</sup>

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CHAIRMAN NAZARIAN: . . . And you've shifted the risk, the financial risk from the company to the ratepayers, right? You will have collected all this money, however many million dollars it is, in between rate cases, you'll have it, and it won't be earmarked for these projects, it will go into the pile and you spend it however you spend it, right?

MR. GAUSMAN: It will be used to help finance the programs. All of the revenue that we get in helps us to finance our overall capital program.

CHAIRMAN NAZARIAN: It's fungible money to the two companies.

MR. GAUSMAN: Yes.

CHAIRMAN NAZARIAN: So the big difference between today and in RIMville, is millions of additional dollars will have gone from customers' pockets to the company to achieve the exact same reliability goals, right? You're not proposing to take on any new reliability burden, and I understand that. But it's the exact same reliability obligation, it's just more money sooner, right?

MR. GAUSMAN: Yes. . . .<sup>140</sup>

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<sup>139</sup> JT Tr. 279, lines 11-21.

<sup>140</sup> JT Tr. 386, line 12 – JT Tr. 387, line 13.

VII. THE COMMISSION SHOULD REJECT PEPCO'S PROPOSAL TO INCREASE THE CURRENTLY AUTHORIZED ROE TO 10.75% AND, INSTEAD, UTILIZING STAFF'S ROE ANALYSIS AS A BASIS, SHOULD ADOPT AN 8.43% ROE FOR THE COMPANY IN THIS PROCEEDING, WHICH CONTINUES TO INCLUDE A 50 BASIS POINT REDUCTION FOR THE BSA.<sup>141</sup>

A. MR. HEVERT'S 10.75% PROPOSED ROE IS EXTREMELY EXCESSIVE.

Pepco witness Hevert proposed that the Commission should increase the Company's authorized ROE in this proceeding to 10.75%<sup>142</sup> from the current level of 9.83% approved in Pepco's last rate proceeding, Case No. 9217.<sup>143</sup> On the other hand, Staff witness Campbell has recommended that Pepco's ROE be reduced to 7.90%.<sup>144</sup> The revenue requirement differential between Pepco's and Staff's positions is quite large at \$25,063,000<sup>145</sup> and underscores just how excessive Mr. Hevert's proposed ROE is.

Although Montgomery County will leave to the expert witnesses the academic discussion of the various methods of determining an appropriate ROE, certain serious errors made by Mr. Hevert are clear from the record.

1. MR. HEVERT FAILS TO PROPERLY ACCOUNT FOR HISTORICALLY LOW INTEREST RATES.

Even Mr. Hevert agreed that "interest rates right now are at historically low levels,"<sup>146</sup> and he could not recall another period of time this prolonged where they had remained so low.<sup>147</sup> The cost of money in today's environment surely does not support an increase in the rate of return, as

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<sup>141</sup> The authorized ROE for Pepco may need to be further adjusted downward, as discussed in Section III.B. of this Initial Brief above, as the imprudence disallowance amount regarding Pepco's reliability O&M and capital expenditures.

<sup>142</sup> Pepco Ex. 20, p. 87, line 19.

<sup>143</sup> Order No. 83516 at p. 58.

<sup>144</sup> Staff Ex. 12, p. 1, lines, 16-17.

<sup>145</sup> Analysis of Proposed Rate Increase – Position by Party, filed on May 18, 2012, at p. 2, line 45.

<sup>146</sup> JT Tr. 844, lines 15-20.

<sup>147</sup> JT Tr. 845, lines 3-6.

Mr. Hevert has proposed. In fact, the difference in the cost of long-term debt between Pepco in this Case No 9286 of 6.59% and its sister company Delmarva in the companion Case No. 9285 of only 5.31% has resulted, at least in part, because of the timing of the respective companies' debt offerings, resulting in Pepco's customers incurring nearly \$6.5 million more because of this interest rate differential.<sup>148</sup> Pepco's customers should at least have the reality of today's historically low cost of money reflected in a lower ROE.

2. MR. HEVERT'S PROXY GROUP IS NOT COMPARABLE TO PEPCO BECAUSE IT IS COMPRISED OF COMPANIES THAT GENERATE ELECTRICITY.

Mr. Hevert's proxy group consists entirely of integrated electric companies that generate electricity as well as distribute it.<sup>149</sup> Mr. Hevert agreed with Chairman Nazarian that because of their ownership of electric generation, there is a tremendous amount of dissimilarity between his proxy group companies and Pepco.<sup>150</sup> For example, AEP and Southern are substantially larger than Pepco, have substantial amounts of coal-fired generation, and bear very substantial regulatory scrutiny and operating risks because of that coal-fired generation.<sup>151</sup> Mr. Hevert further agreed with Chairman Nazarian that: "Those are all factors that don't apply one whit to the PHI companies."<sup>152</sup> Moreover, AEP is in the midst of restructuring in Ohio, which is a problem for AEP, but does not apply to Pepco.<sup>153</sup>

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<sup>148</sup> JT Tr. 81, line 18 – JT Tr. 82, line 12.

<sup>149</sup> JT Tr. 889, lines 2-7.

<sup>150</sup> JT Tr. 889, lines 15-22.

<sup>151</sup> JT Tr. 889, line 23 – JT Tr. 890, line 18.

<sup>152</sup> JT Tr. 890, lines 18 -21. See also JT Tr. 891, line 13 – JT Tr. 892, line 9.

<sup>153</sup> JT Tr. 892, line 10 – JT Tr. 893, line 3.

3. MR. HEVERT UTILIZES LESS THAN OBJECTIVE, OUTCOME-ORIENTED SOURCES IN HIS DCF ANALYSIS.

Staff witness Campbell in his discounted cash flow (“DCF”) analysis utilized Value Line because it is the largest, independent, objective, most widely circulated investor service. On the other hand, Mr. Hevert has relied on other sources that less objectively seek a particular outcome.<sup>154</sup>

4. MR. HEVERT TOTALLY INAPPROPRIATELY ADVOCATES ELIMINATING THE 50 BASIS POINT BSA DOWNWARD ROE ADJUSTMENT WHILE STILL RETAINING THE BSA FOR PEPCO.

Mr. Hevert wants Pepco to retain the BSA but no longer have its authorized ROE reduced by 50 basis points in exchange for the continuation of this cost tracking mechanism that has proven so economically beneficial and risk reducing for Pepco.

In 2007, the Commission in Case No. 9092 adopted the BSA for Pepco,<sup>155</sup> removing the Company’s greatest risk, which was the fluctuations that would occur in its throughput because of weather. In doing so, the Commission cited the number one public policy that the BSA serves:

First, it reduces risk and therefore reduces the Company’s cost of capital. This reduction in the cost of capital redounds to the benefit of customers as is evident in the 50 basis point reduction in the return on equity authorized herein.<sup>156</sup>

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<sup>154</sup> JT Tr. 663, line 15 – JT Tr. 665, line 3.

<sup>155</sup> Order No. 81517, In the Matter of the Application of Potomac Electric Power Company for Authority to Revise Its Rates and Charges for Electric Service and for Certain Rate Design Changes, Case No. 9092 (July 19, 2007) at p. 81.

<sup>156</sup> *Id.* The transcript of the May 3, 2012 first quarter 2012 PHI earnings call with analysts (which Chairman Nazarian cited to during the hearing regarding PHI’s increased earnings over the first quarter of 2011 – see Pepco Tr. 107, line 5 – Pepco Tr. 108, line 2) reveals that PHI Chairman, President, and CEO Joseph Rigby on at least two occasions stressed the importance in Maryland and the District of Columbia of the decoupling of its distribution revenue from consumption, and PHI Senior Vice President and CFO Frederick Boyle responded to an inquiry regarding the amount of help PHI received from decoupling “to offset the weak weather demand” by stating that “decoupling was worth about \$0.04 for the quarter for us.”

Then, in Pepco's last rate proceeding in 2010 in Case No. 9217, the Commission reaffirmed both the 50 basis point reduction in the Company's ROE and the significant risk reduction Pepco enjoys because of the RIM:

The Commission concludes that the BSA significantly lowers Pepco's financial risk, and that a 50 basis points reduction to its ROE, as we applied in the recent Delmarva rate case, Case No. 9192, is appropriate. The BSA clearly reduces the Company's revenue volatility, making the Company a less risky investment than it would be without the BSA (and, as Dr. Morin acknowledged, objectively unrisky<sup>157</sup>). Staff witness Ermer's analysis indicated that the BSA accounted for 25% of the Company's earnings, and lack of the BSA could have reduced Pepco's rate of return by 116 basis points. Further, there is precedent for this reduction in the previous Pepco rate case. We conclude for purposes of calculating the BSA adjustment that Pepco offers shareholders a relatively low risk investment.<sup>158</sup>

Absolutely nothing has changed that has removed this foremost public policy benefit that the Commission found was the fundamental trade-off for Pepco to obtain the BSA. As Pepco's chief policy witness Mr. Kamerick acknowledged to Chairman Nazarian, over the life of the BSA since 2007, it has been significantly revenue positive for Pepco.<sup>159</sup>

Nevertheless, Mr. Kamerick stated in this proceeding that he would like to change his answer from Case No. 9217, "where he conceded at hearing that he would rather have a 50 basis point BSA adjustment in this case than no BSA decoupling mechanism at all,"<sup>160</sup> and instead in

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<sup>157</sup> Dr. Morin was Pepco's witness on ROE in its last rate case, who apparently Pepco determined should be substituted for by Mr. Hevert in this Case No. 9286!

<sup>158</sup> Order No. 83516 at p. 55 (footnotes omitted).

<sup>159</sup> JT Tr. 184, line 7 – JT Tr. 185, line 3.

<sup>160</sup> Order No. 83516 at p. 55 (footnote omitted).

Case No. 9286, he would rather have the higher ROE and no BSA.<sup>161</sup> Because the BSA was originally proposed by Pepco, the Commission could accept Mr. Kamerick's proposal and terminate the BSA, in which case, the quid pro quo 50 basis point ROE reduction would also end.

Assuming, though, that the Commission wishes to continue the BSA, then it is instructive to note that even Mr. Kamerick recognized that the BSA and the 50 basis point ROE reduction are part of an inseparable package. Thus, when he proposed to change his answer, in order to eliminate the 50 basis point ROE reduction, Mr. Kamerick realized that the BSA would also be eliminated. This is in sharp contrast to Mr. Hevert's radical proposal to overturn all of the Commission precedent on this issue and award Pepco both continuation of its BSA and elimination of the 50 basis point ROE reduction. This is yet another of the meritless heads-Pepco-wins/tails-the-customers lose proposals that Pepco has advocated in this Case No. 9286, and it, like the others, should be summarily rejected by the Commission.

#### B. THE COMMISSION SHOULD AUTHORIZE AN 8.43% ROE FOR PEPCO.

Instead of Mr. Hevert's obviously excessive 10.75% ROE proposed by Pepco, the Commission should authorize an 8.43% ROE for Pepco, utilizing Staff witness Campbell's 7.90% ROE recommendation<sup>162</sup> as the basis and then adjusting upward most liberally to Pepco's benefit. As Mr. Campbell explained, Staff has presented what the ROE would be using different methods in order to comply with the Commission's preference for seeing the results under a variety of models.<sup>163</sup> Those various results, utilizing five different methods, including Standard DCF, IRR, ECAPM, CAPM, and Build-up RP, are shown on Exhibit GMCSRB-2 attached to Mr.

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<sup>161</sup> JT Tr. 129, line 15 – JT Tr. 131, line 1.

<sup>162</sup> Staff Ex. 13, p. 1, lines 14-15.

<sup>163</sup> JT Tr. 651, lines 7-22.

Campbell's surrebuttal testimony.<sup>164</sup> Mr. Campbell utilized the median of the five results, which was 8.34%, added 6 basis points for flotation cost, subtracted 50 basis points for the BSA risk adjustment, and arrived at his 7.90% ROE recommendation.

He was asked, though, about whether the result of using a particular method was so low that it should be treated as an outlier, how much weight should be given to a particular method's result, and whether it is more appropriate to use a median or a mean in reaching an ROE recommendation.<sup>165</sup> Because some subjective judgment is involved in this process, Montgomery County is willing to err completely in Pepco's favor by utilizing only the three highest of the five results from Mr. Campbell's analysis, i.e., 9.74% Standard DCF, 8.52% ECAPM, and 8.34% Build-up RP, and computing their mean, rather than their lower median, to arrive at 8.87%. This number should then be increased by 6 basis points for Mr. Campbell's flotation cost adjustment and decreased by the 50 basis point BSA risk adjustment, which yields an ROE for Pepco of 8.43%.

Montgomery County submits that 8.43% is an eminently reasonable authorized ROE for Pepco. As a check, this recommended ROE differs by only 7 basis points from the 8.50% ROE recommended by OPC witness Rothschild and is well within his market based cost of equity range of 8.09% to 8.82%.<sup>166</sup> The adoption of an 8.43% ROE would reduce the downward revenue adjustment of \$25,063,000 from Mr. Hevert's unreasonable, excessive 10.75% proposal that would result from Mr. Campbell's proposed 7.90% ROE, to an amount close to the \$19,109,000 downward adjustment shown for Mr. Rothschild's 8.50% proposed ROE.<sup>167</sup>

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<sup>164</sup> Staff Ex. 13, attached Exhibit GMCSRB-2.

<sup>165</sup> See JT Tr. 653, line 4 – JT Tr. 661, line 17; JT Tr. 665, line 15 – JT Tr. 668, line 6.

<sup>166</sup> Ex. OPC 25, p. 2, lines 5-15.

<sup>167</sup> Analysis of Proposed Rate Increase – Positions by Party, filed on May 18, 2012, at p. 2, line 45.

## CONCLUSION

Montgomery County respectfully requests that, on the basis of the record in this Case No. 9286, the Commission:

- (i) fully and firmly enforce its holding in Order No. 84564, issued in Case No. 9240, that “[i]n the Company’s next rate case, the Commission will review reliability spending in 2011-2012, and will disallow the amount that is larger due to the Company’s imprudent management in earlier years,”<sup>168</sup> particularly in light of the complete stonewalling on this issue by Pepco that amounts to a collateral attack on that order, as evidenced by the Company’s adamant refusal to even attempt to meet its burden of proof,
- (ii) adopt each of the adjustments proposed by Montgomery County in this Initial Brief regarding the disallowance of cost recovery because of Pepco’s imprudence regarding tree trimming, storms, reliability related O&M expenses, and reliability related capital expenditures,
- (iii) disallow recovery of all of the costs incurred by Pepco relating to the investigation in Case No. 9240, which proceeding resulted in the finding of Pepco’s managerial imprudence because of the bottom quartile reliability of the service it has provided for years to its customers,
- (iv) reject Pepco’s request for any type of regulatory lag mitigation mechanism, including its proposed fatally flawed RIM and forecasted or projected test year,
- (v) authorize an 8.43% ROE for Pepco, that includes the historical 50 basis point BSA downward risk adjustment, and
- (vi) adopt all other appropriate adjustments to Pepco’s proposed revenue requirement advocated by the Staff and OPC.

Finally, Montgomery County endorses the following thoughts expressed by Commissioner Williams during the evidentiary hearing in this Case No. 9286:

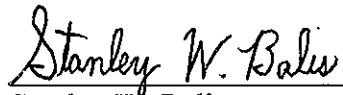
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<sup>168</sup> Order No. 84564, at pp. 3-4.



COMMISSIONER WILLIAMS: Then I go back to what the Chairman has said, you know, who is it that's going to end up paying at the end? And not rightfully so, but I think that it's going to be the consumers if we rule on the fact of paying the company 68 million dollars<sup>169</sup> that they are asking for. And so I don't believe it's a situation where the company and the consumer are going to be hurt. I think it's going to be the consumer. And that's not a good thing.<sup>170</sup>

Respectfully submitted,



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May 31, 2012

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<sup>169</sup> In the original "Application of Potomac Electric Power Company for an Increase in Its Retail Rates for the Distribution of Electric Energy," filed on December 16, 2011, Pepco stated at page 2 that the Company was seeking a \$68,385,000 rate increase. That number has subsequently been revised such that the increased revenue requirement sought by Pepco is now the still quite sizable sum of \$66,207,000, according to the Analysis of Proposed Rate Increase – Position by Party, filed on May 18, 2012, at p. 1, line 45.

<sup>170</sup> JT Tr. 990, lines 13-22.



## CERTIFICATE OF SERVICE

I hereby certify that on this 31<sup>st</sup> day of May, 2012, a copy of the foregoing Initial Brief of Montgomery County, Maryland was served electronically and by first-class mail, postage prepaid, on all parties on the Service List in Case 9286:

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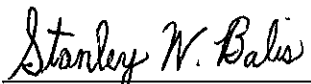
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